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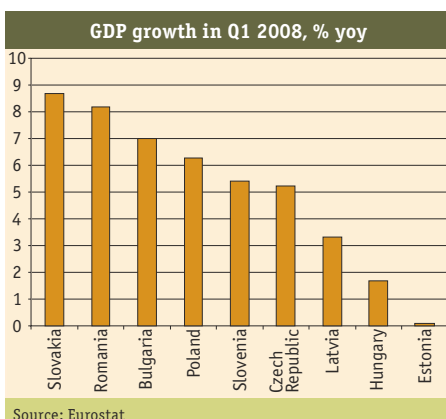
### Summary

- In Q1 2008, the Bulgarian economy grew by 7% year over year (yoy), which was the 3rd highest rate in the EU.
- In January-May 2008, the budget surplus amounted to Lev 2.3 billion, or 3.7% of projected full year GDP. At the end of May 2008, government and government-guaranteed debt stood at €5.3 billion, or 16.8% of GDP.
- Seasonal deflation occurred in June 2008, with the consumer price index (CPI) decreasing by 0.2% month over month (mom). In the first half of 2008, CPI rose 4.6% year to date (ytd).
- Producer prices continued to grow rapidly. The producer price index (PPI) rose by 1.5% mom in May 2008. In the first five months of 2008, PPI increased by 6.1% ytd.
- In January-May 2008, the current account (CA) deficit reached 9.3% of projected full year GDP. Due to high capital inflow, the overall balance amounted to 2.7% of GDP.
- Bulgaria was ranked 44th in Forbes' 2008 Best Countries for Business, which is 24 positions better than in the previous year.

### Economic Growth

In Q1 2008, the Bulgarian economy expanded by 7.0% yoy, which is 1.5 pp higher than in Q1 2007. Acceleration took place due to more favorable trade dynamics. Exports accelerated to 9.2% yoy in Q1 2007 from 3.7% yoy in Q1 2008 and outpaced imports, which decelerated to 5.8% yoy from 14.7% yoy. At the same time, both consumption and investment slowed down, to 4.7% yoy from 6.0% yoy and to 15.5% yoy from 35.9% yoy respectively. Still, the trend of investment growing significantly faster than consumption continued.

On the production side, services led growth with an 8.3% increase yoy. Industry was also dynamic, expanding by 7.7% yoy. However, agriculture shrunk by 1.6% yoy. In comparison, these three sectors increased by 3.6%, 10.1% and 0.3% yoy respectively in Q1 2007. So compared to the corresponding period of the previous year, performance of services



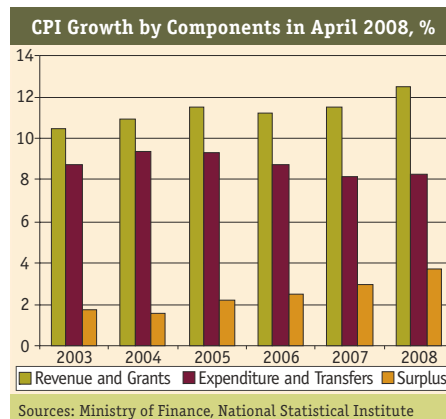
significantly improved, while that of industry and agriculture slightly worsened.

Remarkably, with 7% yoy growth, the Bulgarian economy continues to be one of the most dynamic in the region. In Q1 2008, it ranked third by GDP growth among EU countries, being outpaced only by Slovakia and Romania.

### Fiscal Policy

The government of Bulgaria continues to exercise prudent fiscal policy. In 2008, it envisages growth in budget revenues and expenditures by 13.1% yoy, to Lev 18.3 billion and 16.3 billion respectively. The resulting difference of Lev 2 billion will be allocated between a contribution to the EU budget (Lev 0.6 billion) and the budget surplus of Lev 1.3 billion (or 2.1% of projected 2008 GDP).

Current indicators suggest that it is highly likely that the 2008 budget will be executed according to plan. In January-May 2008, the fiscal surplus amounted to Lev 2.3 billion, which is a growth of 42% yoy. This was helped by strong revenue growth combined with a moderate increase in expenditures.



On the back of fast economic growth, budget revenues and grants rose quickly, by 22.9% yoy. In particular, tax revenues, which comprised 86.5% of all revenues and grants, grew by 26.4% yoy. More than half of this increase was due to brisk VAT receipts, which rose by 32.1% yoy, with their share in total tax revenues reaching 45.1%. Profit tax revenues also grew faster than that from taxes on average — by 30.0% yoy — and amounted to 18.6% of all tax receipts.

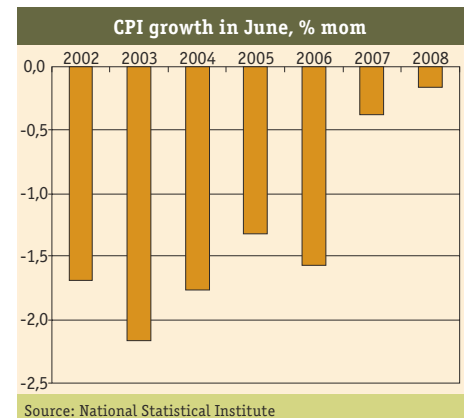
At the same time, outlays were expanded at a significantly slower pace; budget expenditures and transfers went up by 15.6% yoy. In particular, the increase in expenditures (which constituted 61.6% of expenditures and transfers) was only 5.4% yoy. While growth was recorded in wages and salaries (14.6% yoy) and maintenance (5.6% yoy), capital expenditures fell by 0.3% yoy and social expenditures were reduced by 2.3% yoy. At the same time,

the increase in transfers (which comprised 38.4% of expenditures and transfers) was brisk — 30.4% yoy. Most transfers were allocated to municipalities (41.9% of the total amount) and to the Social Security Fund (41.6%). Transfers to municipalities went up by 23.7% yoy, and those to the Social Security Fund by 39.9%.

By the end of May 2008, government and government-guaranteed debt totaled €5,304 million, or 16.8% of GDP. Domestic and foreign debt made up 30.1% and 69.9% of total debt, respectively. Since the beginning of the year, both domestic and foreign government debt decreased, by 2.5% ytd and 9.0% ytd respectively.

### Monetary Sector

In June 2008, seasonal deflation of 0.2% mom took place. It was caused by a drop in prices of food and non-alcoholic beverages by 2.3%. At the same time, the other categories of goods and services did not become cheaper. The fastest price growth was observed in transport (3.3% mom) due to rising fuel costs, and in alcoholic beverages and tobacco (2.1%) due to the continuing adjustment of tobacco excise taxes to EU levels. Additionally, there was relatively high price growth in restaurants and hotels (1.0% mom) and recreation and culture (0.8% mom), which must have been caused primarily by growing labor costs. Price growth in utilities was 0.8% mom and is explained by increasing fuel prices.



According to H1 2008 data, CPI grew by 4.6% ytd during that period. The steepest price increase occurred in transport (12.2% ytd), and alcoholic beverages and tobacco (11.2% ytd). Also, prices rose considerably in miscellaneous goods and services (6.7% ytd) and restaurants and hotels (6.6%). The rest of the CPI categories were subject to inflation to a lesser extent. Moreover, deflation was observed in one of them: prices in telecommunication decreased by 0.3% ytd due to tightening competition among the operators.

Producer prices grew more rapidly than consumer prices. In January-May 2008, PPI increased by

6.1% ytd (in particular, by 1.5% mom in May 2008). Inflation was especially high in mining — 10% ytd, primarily due to a price hike in metal ore mining by 12.5% ytd. Inflation in manufacturing was somewhat lower — 6.8% ytd — and the bulk of it was caused by a price increase in basic metals by 7.8% ytd. Price growth was moderate in electricity, water and gas supply — only 1.2% ytd in January-May 2008; what's more, deflation of 0.7% mom was registered in this sector in May 2008.

In H1 2008, loans to Bulgarian non-financial corporations and households grew substantially, by 21.8% ytd and 18.2% ytd respectively. Among the latter, consumer credit increased by 17% ytd and housing loans increased by 20.6% ytd; the shares of these two kinds of loans in total loans to households were 41.8% and 41.6% respectively. Notably, while households made their borrowings mostly in levs, enterprises preferred credits in foreign currency (almost exclusively euro). Interestingly, the phenomenon of enterprises more inclined to borrow in foreign currency than households is rare in the region; among New Member States of the European Union, the only other country where this is observed is Slovakia.

### International Trade and Capital

In January-May 2008, the CA deficit totaled €3,059 million, or 9.3% of projected full-year GDP. At the same time, the financial account amounted to €3,511 million, or 10.7% of GDP. The sum of these two accounts was €451 million, which is a decline of €224 million yoy. However, the overall balance reached €874 million (or 2.7% of GDP), improving by €558 million yoy. The fact that the overall balance was significantly higher than the sum of the CA and financial account is explained mostly by errors and omissions, and also by favorable changes in the capital account, which increased to €200 million in January-May 2008 from €50 million in the first five months of 2007.

The major reason for the large negative value of the CA remains the deficit on the goods account, which amounted to €3,366 million in January-May 2008, or 10.3% of projected full year GDP. The increase in the goods deficit was 24.6% yoy, as a result of export and import growth by 26.1% and 25.6% yoy respectively. In turn, brisk growth of both exports and im-

ports was to a large extent affected by rising world prices, especially for fuel and raw materials. It was primarily due to the rapid price increase that exports of non-ferrous metals and petroleum products demonstrated (twice as high as the average pace of growth), which account for almost half of the increase in total exports, while accounting for only around a quarter of total exports. Likewise, crude oil and natural gas made up a quarter of imports growth, constituting only one sixth of total imports.

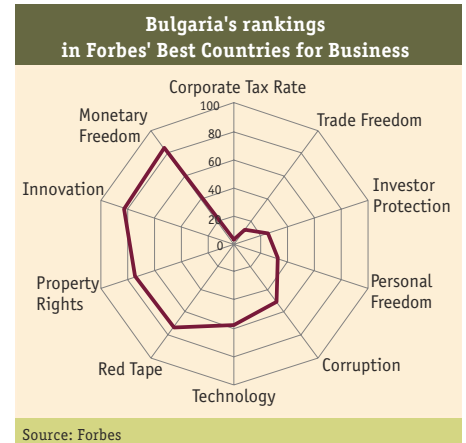
At the same time, capital inflows to Bulgaria continue to be high. In January-May 2008, the financial account had a large surplus, which was caused mainly by strong FDI and growing bank borrowing from non-residents combined with decreasing deposits of domestic banks abroad. Specifically, FDI reached €1,705 million in January-May 2008. What's more, it is highly likely that this figure will be increased significantly after a number of revisions, which will take into account the data from the additional enterprises' reports. Meanwhile, the comparison of this first preliminary statistic with the initial estimate of FDI in January-May 2007 (which was published in July 2007 and was equal to €1,530 million) shows that FDI increased by 11.4% yoy in the first five months of 2008. Based on this fact and taking into account the current (revised several times but not yet final) FDI statistic for January-May 2007 equal to €2,020 million, one can conclude that the preliminary data for FDI in the first five months of 2008 considerably underestimates the actual amount of FDI during that period.

### Other Developments and Reforms Affecting the Investment Climate

This year, Bulgaria was ranked 44th among 121 countries in Forbes' Best Countries for Business, advancing 24 positions in comparison to the previous year. According to the ranking, Bulgaria's strongest features are its corporate tax rate, trade freedom, and investor protection. Notably, with its 10% corporate tax, Bulgaria became the third best country (after Italy and Switzerland) by this indicator. At the same time, Bulgaria's weaknesses are in monetary freedom, innovations, and property rights.

In addition, Forbes says that while Bulgaria's governments have been committed to reforms and fis-

cal prudence, they have failed to tame inflation and reduce the current account deficit. According to



Forbes, the biggest challenges for Bulgaria are corruption in public administration, a weak judiciary, and organized crime.

In 2008, Bulgaria's performance in the Best Countries for Business was close to that of Croatia, Turkey, and Romania. The country outperformed Macedonia, Greece, Ukraine, and Russia. However, Bulgaria lagged behind most Central and Eastern European countries, led by Estonia, which managed to get into the top ten countries and was as much as 17 positions higher than the closest follower, Slovenia.

